Office - Supreme Court, U.S.
FILED
OCT 14 1982
ALEXANDER L. STEVAS,
CLERK

No. 81-523

IN THE

Supreme Court of the United States

October Term, 1982

CONTAINER CORPORATION OF AMERICA,

Appellant,

vs.

FRANCHISE TAX BOARD,

Appellee.

On Appeal from the Court of Appeal of the State of California for the First Appellate District.

BRIEF OF FRANK M. KEESLING AS AMICUS CURIAE IN SUPPORT OF APPELLEE.

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BRIEF OF FRANK M. KEESLING AS AMICUS CURIAE IN SUPPORT OF APPELLEE.

Interest of Amicus Curiae.

Both the Appellant and the Appellee have consented to the filing of this brief.

Amicus Curiae is not representing anyone in this matter. He has been interested in the problem of the allocation and apportionment of income for state tax purposes for nearly fifty years. As Counsel to the California Franchise Tax Commissioner (the predecessor of the California Franchise Tax Board) during the years 1935-1939, he made many contributions to the state's allocation and apportionment policies, including the one which is at issue herein, *i.e.*, the requirement for the filing of a combined report in instances where two or more commonly owned corporations are engaged in the conduct of a unitary business partly within and partly without the State of California. He has written and lectured on this subject fairly extensively.

The Issues.

During the years involved herein, *i.e.*, 1963, 1964 and 1965, Appellant, a domestic corporation, was engaged in the manufacture and sale of containers in various states of the United States, including the State of California. It acknowledges that this business was unitary in nature, and that the income attributable to the various states may properly be computed by the use of an appropriate apportionment formula rather than by separate accounting.

During the same years Appellant owned all of the stock of various foreign corporations, and a controlling stock interest in various other foreign corporations, all of which were engaged in the manufacture and sale of containers outside the United States. The businesses of the foreign corporations were similar to the business of the Appellant in the United States but varied somewhat due to different market demands.

Appellant contends that the foreign subsidiaries were engaged in the conduct of separate and discrete businesses, and that the income therefrom was properly computed by the separate accounting method and that none of such income was attributable to sources in California or to any other state.

Appellant further contends that even if it should be held that the Appellant and the foreign subsidiaries were engaged in the conduct of a unitary business partly within and partly without the State of California, it is unconstitutional, for a number of reasons, to include the income of the foreign corporations in a combined report.

ARGUMENT.

I.

DURING THE YEARS IN QUESTION APPELLANT WAS ENGAGED WITH ITS SUBSIDIARIES, FOREIGN AS WELL AS DOMESTIC IN THE CONDUCT OF A UNITARY BUSINESS.

A. This Case Is Not Controlled by Woolworth.

Appellant states that the facts in the instant case are strikingly similar to those in *F. W. Woolworth Co. v. Taxation & Revenue Dept.*, ... U.S. .... . (App's. Br. 10.) This is simply not true. In fact, it would be more accurate to say that the facts in the instant case are strikingly different than those in *Woolworth*. Although there are similarities such as common ownership of the subsidiaries, there are many elements of unity in the instant case which were not present in *Woolworth*. They will be referred to and discussed below.

Appellant contends that for a business to be unitary there must be a continuous flow of goods between the different taxing jurisdictions in which the business is conducted. (App's. Br. 41.) This is wishful thinking on Appellant's part. *Woolworth* and other cases cited by Appellant simply do not support this contention. The opinion in *Woolworth* clearly recognizes that in determining the existence of a unitary business, such matters as common management, centralized performance of various functions and economies of scale may be considered.

B. Definition of a Unitary Business.

The real test of a unitary business is whether the operations within the state make substantial contributions to the functioning of the business as a whole. If so, and if the entire business is profitable, then some portion of the total income should be attributed to the operations within the taxing state. This can be accomplished by the application of the formula method which the separate accounting method often fails to do. This is fully established by *Butler*

Bros. v. McColgan, 17 Cal.2d 664 (1941), aff'd 315 U.S. 501 (1942).

Butler Bros. operated seven wholesale department stores located in as many different states. The business was managed and controlled from executive offices in Chicago, where the goods for all seven stores were centrally purchased. Although the business as a whole produced a substantial profit, Butler Bros. reported that a substantial loss was sustained by its California store.

It was stipulated that by buying in large quantities, the company was able to achieve a purchasing profit. It was able to buy in large quantities only because it sold in large quantities. The California store contributed to the sales, and in so doing helped the company obtain a purchasing profit which was beneficial to the business as a whole. Both the California Supreme Court and this Court held that the business was unitary and that it was permissible for California to attribute a portion of the total income to the state by the application of the three factor formula of property, payroll and sales.

A unitary business has been defined as one where there is a relationship of dependency or contribution between the portion of the business within the taxing state and the portion of the business outside such state. G. Altman and F. Keesling, *Allocation of Income in State Taxation*, 101 (1946); (2d Ed. 1950).

The foregoing definition of a unitary business was approved by the California Supreme Court in *Edison California Stores, Inc. v. McColgan*, 30 Cal.2d 472 (1947). From there it has spread all over the country, and has been frequently cited in briefs, law review articles and opinions of appellate courts, including the Supreme Courts of many states. For a comparatively recent example, *see* the opinion of the Wisconsin Supreme Court in the *Exxon* case, 90 Wisc.2d 700, 281 N.W.2d 94 (1979). In that opinion, the Wisconsin Supreme Court quoted in full the dependency or

contribution definition of a unitary business as set forth in the above-referred to treatise. *See also*, this Court's opinion in *Exxon Corp. v. Wisconsin Department of Revenue*, 447 U.S. 207 (1931).

Where there is trade between different taxing jurisdictions, *e.g.*, where a corporation manufactures goods in one state and the goods are sold by it or by affiliated corporations in other states, it is clear that the manufacturing and selling operations complement one another, and each makes a substantial—even essential contribution to the overall enterprise. But even where there is no such trade, a business conducted in several jurisdictions may still be unitary. For example, a corporation operates a mine in state B. The ore extracted there is processed there, and the metal obtained is sold there. The business is managed and controlled from executive offices maintained in state A. Again, these operations complement one another, and each makes substantial contributions to the functioning of the business as a whole. The business is accordingly unitary, and the income should be apportioned by formula. *See* Keesling and Warren, *The Unitary Concept in the Allocation of Income*, Hastings L.J. Vol. 12, No. 1, 42, 50 (1960).

The conclusion that a business may be unitary even though there is no trade between different jurisdictions in which the business is conducted is fully supported by *Superior Oil Company v. Franchise Tax Board*, 60 Cal.2d 406, 34 Cal.Rptr. 545 (1963). Superior Oil Company was what is known as a non-integrated oil company. It explored for, drilled for and extracted oil but did not refine the oil or sell refined products in different states as in the case of integrated companies. Instead, all of the oil produced in a given state was sold at the well where produced. It was engaged extensively in the production and sale of oil in California as well as other states. Although the Franchise Tax Board is noted for the use of the formula method, in this case it believed that the operations in the different states

were sufficiently separate so that the income could be computed by the separate accounting method rather than by formula. The California Supreme Court, however, held otherwise and required that the formula method be employed largely because of extensive common management in California.

C. Contributions of Appellant to the Functioning of the Foreign Subsidiaries.

During the years in question, Appellant made numerous contributions to the operation of the foreign subsidiaries which were not present in the case of *Woolworth*. These contributions include the following:

1. Financing.

Unlike *Woolworth*, Appellant provided substantial financing to the foreign subsidiaries. This is an important factor in determining whether a business is unitary or separate. There were outstanding loans of several million dollars at the end of each year in question. JA 69 Stip ¶ 133. In addition, Appellant guaranteed a substantial amount of loans made by local lenders. JA 70 Last sentence of Stip ¶ 133.

In the aggregate, the loans made by Appellant and the loans guaranteed by it amounted to approximately 60% of the financing required by the subsidiaries. It is possible—even probable that the remaining 40% of the subsidiaries' financing requirements could not have been obtained from other sources were it not for the fact of Appellant's loans and guarantees. Thus it may well be that directly or indirectly, Appellant was responsible for the entire amount of financing required by the subsidiaries without which they could not have functioned.

2. Furnishing Technical Services.

The Appellant entered into agreements with six of the foreign subsidiaries, pursuant to which it agreed to furnish technical services to them. JA 74 Stip ¶ 144. (The agree-

ments are reproduced as Exhibit F to the Stipulation of Facts).

The agreements provided that Appellant would provide advice and consultation to each of the six subsidiaries concerning manufacturing techniques, engineering, design, architecture, insurance and cost accounting.

Some of the agreements refer to the fact that Appellant has been engaged in the production of containers for a long period of time and has accumulated much valuable experience which it agrees to make available to the six subsidiaries.

Appellant did not have a technical service agreement with the Colombia or Venezuela subsidiaries, since such agreements are not allowed by these countries. JA 74 Stip ¶ 144. Appellant did, however, provide such technical service to these subsidiaries.

The phrase "technical services" is a synonym for "know-how," for which American business is famous throughout the world. The furnishing of such service was undoubtedly of great value to the subsidiaries to which furnished, and strongly indicates that the businesses of Appellant and its subsidiaries were unitary—not separate in character.

3. Purchases of New Equipment.

Appellant arranged for the purchase of substantial quantities ($5 to 7 million dollars per year) of new equipment for the use of the subsidiaries. JA 77 Stip ¶ 148. Such equipment was purchased for the most part in the United States where Appellant functioned. Each subsidiary would perform its own engineering studies and submit its specifications to Appellant's purchasing department which would then locate the desired equipment, order it and arrange for its shipment to the subsidiary desiring it.

This function of purchasing equipment is very similar to the function performed by Butler Bros. headquarters office in purchasing goods for its seven wholesale houses. The

principal difference is that the goods purchased by Butler Bros. were purchased for resale by the seven divisions, whereas in the instant case the equipment purchased was purchased for use by the subsidiaries.

Furthermore, as in *Butler Bros.*, it is highly probable that by buying the equipment centrally in large quantities, substantially lower prices were obtained than would have been if each subsidiary had purchased its own equipment separately. Because of the centralized purchasing and the obtaining of a purchasing profit, Butler Bros. was held to have been engaged in a unitary business. A similar conclusion should be reached here.

4. Sales of Used Equipment.

From time to time Appellant would sell to the subsidiaries used equipment which was still in good condition but which was no longer suitable for the requirements of the Appellant bacause of its low capacity or because it was designed for a process no longer used domestically. JA 76 Stip ¶ 147. From the standpoint of the Appellant, it was certainly convenient to have a ready market for its obsolete equipment, and from the standpoint of the purchasing subsidiaries, it was certainly of considerable benefit to be able to purchase useable equipment at a low cost.

5. Sales of Raw Materials.

During each of the years involved Appellant made sales of raw materials to nearly all of the foreign subsidiaries. JA 73 Stip ¶ 141. These sales averaged over one million dollars per year. (Ex. A-8) In addition, Appellant purchased paper and resold it to the subsidiaries. According to this Stipulation, the amounts of such purchases are not available for the three years in question. However, for the three subsequent years, such purchases of paper averaged approximately six million dollars per year. JA 74 Stip ¶ 143. It is possible that the sales of paper amounted to a lesser figure during the years in question. Since the sales of paper for

the year 1966, the closest year to the years in question, amounted to $3,800,000.00, it is reasonable to assume that the sales during the three years in question may have averaged as much as three million per year.

If the sales of paper are added to the sales of other raw materials, a figure of four million dollars is obtained. This represents approximately 5% of the purchases of raw materials made by the subsidiaries. Obviously, this is another significant element of unity.

6. Appellant's Involvement in the Management and Accounting Practices of the Foreign Subsidiaries.

During the years involved Appellant maintained a Foreign Operations Staff consisting of two full-time officers, one part-time senior executive, one part-time controller and one part-time lawyer. JA 65 Stip ¶ 126.

A Mr. Green, Senior Vice President of Overseas Operations, spent approximately 40% of his time on overseas work, a portion of which was handling Appellant's international legal affairs. JA 65 Stip ¶ 127.

A Mr. Lennert Ulvaeus was employed by the Appellant in 1948. In 1963 he was promoted to Vice President of European Operations. JA 66 Stip ¶ 128.

Earl Kaufman, who had held a number of positions with the Appellant since 1933, was named Vice President of Latin American Operations in 1963. He had responsibility for all Latin American operations, which included 25 plants in three countries. Both of these men received remuneration from Appellant and also from a foreign subsidiary. JA 66 Stip ¶ 128.

It was stipulated that Appellant did not dominate the operations of the subsidiaries. Instead, Appellant's policies were to reach decisions by mutual understanding. In addition, it is stipulated that Appellant held local management strictly responsible for its performance. JA 167 Stip ¶ 130.

In addition to Mr. Green, Mr. Ulvaeus and Mr. Kaufman, five other of Appellant's officers were directors of one or more of the subsidiaries. JA 68 Stip ¶ 131.

Appellant required each of the subsidiaries to submit its budgets to it for informational purposes. JA 70 Stip ¶ 134.

Appellant also required each subsidiary to furnish it with monthly financial statements. At the year end more detailed financial statements were required.

Appellant also was involved in the development of the subsidiaries' accounting procedures such as development of formats for the transfer of information to the United States. Such information was needed, not only for the preparation of reports required by the federal government, but also to monitor the performance of the subsidiaries. JA 71 Stip ¶ 136.

All of the above-described matters indicate an involvement by the Appellant with the foreign subsidiaries which would not have occurred if the foreign subsidiaries were separate and independent corporations.

7. Intercompany Transfer of Employees.

During the years in question, 26 officers or employees of Appellant were transferred to one or more of the foreign subsidiaries. The names of such individuals and the positions to which they transferred are set forth in Exhibit D.

In an attempt to denigrate the importance of such transfers, Appellant compares the number of transfers to the total number of its employees in the United States and to the total number of the subsidiaries' employees. (App's. Br. 6.) Such a comparison is completely irrelevant. The individuals transferred were not to perform routine tasks. Instead, they were transferred to perform either executive or managerial services at a very high level. The proper comparison should have been with the total number of individuals employed by the foreign subsidiaries performing similar managerial or executive functions. If such a comparison had

been made, the number of individuals transferred would gain substantial added significance.

It should also be noted that these individuals while employed by Appellant had the opportunity to become quite familiar with various aspects of Appellant's manufacturing operations. This knowledge or "know-how" not possessed by other individuals employed directly by foreign subsidiaries was undoubtedly of invaluable assistance to the foreign subsidiaries.

8. Pension and Other Plans.

It is stipulated that the 26 individuals transferred to foreign subsidiaries remained on the payroll of the Appellant. They continued to receive all employee benefits except participation in the common stock bonus plan. JA 65 Stip ¶ 124(c). Thus, they continued to participate in Appellant's pension plan, retirement plan, and life insurance plan. Obviously, such arrangements would not be made between truly independent entities.

9. Research.

Appellant actively engages in extensive product research, design and market research. During the years in question, approximately 250 people were directly involved in these activities at an annual cost of approximately 4 to 5 million dollars. JA 27 Stip ¶ 56.

Although it is not so stipulated, it is reasonable to assume that the benefits of such research would be shared with Appellant's foreign subsidiaries.

10. Major Policy Matters.

Day to day management decisions were made by the management personnel in the foreign countries. However, most major policy matters, although initiated by foreign subsidiaries, were generally subject to review by Appellant. JA 39 Stip ¶ 74. (App's. Br. 4.)

11. Visits to United States by Officers and Employees of Foreign Subsidiaries.

Although Appellant did not maintain a training program for foreign subsidiary employees, there were approximately 10-12 visits per year for two six-week periods by foreign employees to learn about Appellant's methods of operation. Most visits were by one person at a time, although occasionally two or three people may have visited at one time. Some of the visitors were in control functions—others were plant managers. JA 69 Stip ¶ 132.

As noted above, during the years in question Appellant performed a great many services for the foreign subsidiaries. For the most part, when charges were made at all, the charges were in an amount calculated only to reimburse Appellant for its out-of-pocket expenses in order that it might break even. Independent businesses, however, are not operated on a break even basis,. Instead, the objective of independent businesses is to make a substantial profit over and above the necessary expenditures. If this policy had been pursued with respect to the subsidiaries, the charges would have been increased substantially with the result that the net income of the foreign subsidiaries would have been reduced and the domestic income would have been substantially increased.

D. Non-Arm's-Length Charges.

Appellant contends that the foreign subsidiaries were engaged in the operation of separate, discrete businesses. Its actions, however, belie this contention.

In the following matters, Appellant did not deal with the foreign subsidiaries on an arm's length basis, but instead grossly undercharged for the assistance and services rendered the subsidiaries:

1. Loans and Guarantees of Loans.

During the years in question, Appellant made substantial loans to the subsidiaries. At the end of each year the outstanding loans were as follows:

1963	$7,704,908.00
1964	7,155,714.00
1965	3,223,371.00

It is possible that additional loans may have been made during each year but repaid before the end of the year. (App's. Br. 2 N 1.)

Appellant also guaranteed loans to the subsidiaries by other lenders in substantial amounts, possibly two or three million dollars or more. JA 69-70 Stip ¶ 133. The reference to guarantees is in the last sentence of Stip ¶ 133.

Strange as it may be, there is no reference in either the Stipulation of Facts or in Appellant's brief as to the amount of interest charged on the above loans either long term or short term. However, in the 2952 forms which Appellant filed with the United States with respect to each subsidiary each year, there is an indication that some of the subsidiaries did make interest payments to Appellant. It is not certain whether these payments were made on the long term loans from the parent or the short term loans or on some other type of indebtedness. The amounts of such payments in the aggregate made by all of the subsidiaries for each year were as follows:

1963	$ 19,900.00
1964	95,000.00
1965	59,500.00
TOTAL	$174,400.00

These interest payments might have been adequate on loan advances during each year and repaid during such year, the amounts of which are not set forth in the Stipulation. But if they were intended as payments on the long term loans, the amounts of which are set forth above, they are

hopelessly inadequate. They are far less than what a domestic bank would charge for similar loans and guarantees in the case of an established and highly successful domestic corporation. Assuming that a domestic investor could be found that would be willing to make substantial long term loans to foreign corporations operating in foreign countries, it is certain that the charges would have been much greater than in the case of loans to established successful domestic corporations such as Appellant. There would also have been substantial charges for the loan guarantees.

Thus, it is abundantly clear that Appellant undercharged the subsidiaries in a very substantial amount for interest on loans and loan guarantees.

2. Purchases of New Equipment.

The foreign subsidiaries were also substantially undercharged for the purchase of new equipment.

As noted previously, such purchases amounted to between five and seven million dollars, plus 5% as a brokerage commission and acknowledges that if this function had been performed by independent brokers, the commissions they would charge would probably be somewhat higher. This is a substantial understatement. JA 77 Stip ¶ 148.

Independent companies would not have performed this function advancing the purchase price and assuming the risks of recovery from foreign corporations for a commission anywhere near to 5%. In fact, it is questionable whether such a commission would even cover the out-of-pocket expenses computed in accordance with good accounting practices, which would have taken into account the time and salaries of individuals in checking the specifications from the subsidiaries, locating the equipment, bargaining for the price, arranging for shipment, expenses of secretaries, telephone cost and various other items of overhead.

3. Payments of Salaries to Employees on Subsidiaries' Payroll.

As noted above, 26 of Appellant's employees were transferred to the foreign subsidiaries. These individuals continued to be carried on Appellant's payroll. Although Appellant was reimbursed for the salaries, there is nothing in the Stipulation to indicate that Appellant was reimbursed for the cost of continuing these individuals in various pension, retirement and insurance plans. An independent corporation operating at arm's length would not and could not make such an arrangement.

4. Charges for Technical Services.

The Appellant charged the foreign subsidiaries fairly substantial amounts for providing technical services. These amounts were as follows: JA 75 Stip ¶ 145.

1963	$179,985.00
1964	591,192.00
1965	587,650.00

These charges are large enough to indicate that the furnishing of technical services to the subsidiaries was an important matter and must have required the services of a large number of Appellant's personnel. There is, however, nothing in the record to indicate whether these charges were in excess of the cost of Appellant, equal to such costs or less than such costs. In view of the practice of Appellant in other matters, it would be surprising if these charges were substantially in excess of cost.

5. Reimbursement for the Salaries and Expenses of the Members of the Foreign Operations Staff.

The Foreign Operations Staff consisted of two full-time operations officers and three part-time officers. One of the part-time officers was a Mr. Green who devoted 40% of his time to matters relating to the foreign subsidiaries, including legal services. With respect to the two full-time officers and Mr. Green, there is nothing in the Stipulation of Facts to

indicate that Appellant was reimbursed either for the salaries paid to these individuals or for incidental overhead expenses such as salaries of secretaries and clerical assistants and general overhead incurred in the maintenance of offices. Two of the part-time officers were carried on both Appellant's payroll and the payroll of one of the subsidiaries. It is not indicated how the salaries were apportioned between these corporations.

Presumably all five of the members of the Foreign Operations Staff were members of Appellant's employee benefit plans such as the stock bonus plan, the pension plan, the retirement plan and the group insurance plan. Presumably Appellant was not reimbursed for the contributions to these plans on behalf of the above five individuals.

E. The Underlying Activity.

The determination as to whether a business is unitary should not be made on the basis of corporate forms, but should instead be made on the basis of the underlying activity. *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 440 (1980). This is the philosophy of the combined report. *See* Keesling and Warren, Hastings L.J., Vol. 12, No. 1, 42, 57 (1960) wherein it is stated:

> "In any case where a business would be considered unitary if conducted by one taxpayer, it should likewise be so considered even though conducted by two or more affiliated corporations. Just as a state may look beyond its borders and take into account the entire income of a business in arriving at a determination of the amount of income reasonably attributable to the activities conducted within the state, so in the case of a group of affiliated corporations engaged in the conduct of a business, it may look at the total income of the group to determine the amount of income attributable to the portion of the business conducted within the state by one or more of the members of the group."

When one looks at the underlying activity, it appears that Appellant was incorporated in Delaware in 1926. It took over an existing business which was engaged in the manufacture of containers. Appellant actively continued in this business and expanded the business in the United States to a substantial extent. JA 13 Stip ¶ 22.

After concluding that the supplying of containers to meet the demands of foreign markets might be profitable, Appellant in 1944 extended its business to Colombia and Mexico. The business was further extended to Venezuela, Italy, Holland, Germany and Austria in subsequent years. JA 14 Stip ¶ 25.

Instead of endeavoring to supply the foreign markets with containers manufactured in the United States, it decided to operate plants in the various foreign countries for the following reasons:

1. To avoid the cost of transporting finished products which, in view of the weight of containers, would be very expensive;
2. To avoid import restrictions in various foreign countries; and
3. To obtain the benefits of somewhat lesser cost of labor and property in the foreign countries than those prevailing in the United States.

Except for a few individuals transferred from Appellant, the manufacturing and selling activities in the foreign countries were performed by residents of such countries. Undoubtedly the manufacturing and selling activities in the foreign countries greatly contributed to the success of the portions of the business operated in such countries, and, accordingly, greatly contributed to the earning of income. The services and activities of the Appellant with respect to the foreign operations also contributed greatly to their success and to the earning of income. Thus, these complement one another in the production of a common income. It is

impossible to determine separately and specifically how much income each of the respective activities contributed.

The factual situation here is somewhat reminiscent of that in *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920). The Underwood Typewriter Company manufactured a product in Connecticut which is sold partly there and partly in various other states. The product was charged out to the selling divisions at cost with the result that none of the fairly substantial income of the company was attributed to the manufacturing operations. The selling activities in the different states undoubtedly made substantial—even essential contributions to the earning of the company's income. A similar statement may be made with respect to the manufacturing operations in Connecticut.

This Court held that it was impossible to determine "separately" and "specifically" how much of the total income was attributable to the operations in the respective states. Therefore, it upheld the use of an apportionment formula which attributed 47% of the company's income to Connecticut. A similar result should be obtained here, and for the same reasons.

The value of Appellant's contributions to the foreign operations may be more fully appreciated if consideration is given to the question, What would have happened to such operations if Appellant had not made the contributions it did? Suppose there were no lending of funds, no transfer of knowledge gained from long experience in the production and sale of containers, no purchasing of equipment for the foreign operations, no transfer of raw materials and no transfer of employees to perform executive functions in the foreign countries? Without such contributions, it is probable that the foreign operations would have been unsuccessful. Thus, it may well be that the contributions made by Appellant like the contributions made in the foreign countries were essential to the success of the joint enterprise.

It is true that in *Underwood* there was a flow of goods across state lines. That, however, is not particularly important in determining how income should be apportioned. The important consideration is that functions or activities performed in different jurisdictions complement one another in contributing to a common income and that the amount contributed by each cannot be separately determined.

II.

THE INCLUSION OF FOREIGN SUBSIDIARIES IN A COMBINED REPORT IS CONSTITUTIONAL.

A. Any Double Taxation of the Same Income Resulted From Overstatement of the Foreign Taxable Income.

Income taxes imposed by foreign countries are generally substantially less than those in the United States. Some countries do not impose such taxes—others are imposed at a lower rate than those prevailing in the United States, and in still other countries the administration is so lax that many taxpayers either do not file returns at all, or file returns greatly understating the correct taxable income.

Under these circumstances, there is a great temptation to corporations with extensive business operations here and which also own a number of foreign subsidiaries to undercharge the foreign subsidiaries for various services performed for them, and instead to deduct the cost of such services in the computation of their federal taxable income and in the computation of the taxable income of various states. By this means the foreign taxable income may be substantially increased but the taxable income in the United States will be substantially decreased. Inasmuch as the income in this country is taxed at substantially higher rates than is applicable to the foreign income, substantial "savings" may be effected.

The tax benefits which may be obtained by either not charging foreign subsidiaries for various expenses incurred on their behalf or by understating such charges may be

illustrated by a simple example. X corporation is the parent of a large number of subsidiaries, both domestic and foreign. It owns a 40-story office building in New York which it uses in supervising and servicing both the domestic and foreign subsidiaries. Several hundred employees are engaged in this activity. Although a few of the employees may devote all of their time to either the domestic or the foreign subsidiaries, in the majority of instances, their time is devoted partly to each.

X performs numerous services on behalf of both the domestic and foreign subsidiaries, including advertising, auditing, legal, research, preparation of tax returns or advising with respect to tax matters.

A substantial part of the cost of the office building used by X, which includes depreciation, property taxes and various other maintenance expenses, should be charged against the foreign subsidiaries. There should likewise be charged against the subsidiaries a substantial portion of the salaries of the individuals who work part or full-time on behalf of the foreign subsidiaries.

X corporation decides not to make such charges, since such charges will serve only to reduce foreign income taxes which are imposed at a relatively lower rate—perhaps an average rate of 25% or less. Instead, it files a consolidated federal return with its domestic subsidiaries and deducts the full amount of all such charges in computing its federal taxable income which is taxed at a rate of approximately 50%. Thus, it reduces the overall income tax burden applicable to it and its subsidiaries by substantial amounts. Similar reductions are obtained in the same manner in the income taxes of many states in which the domestic subsidiaries operate.

Of course, the X corporation runs the risk that upon audit, the Internal Revenue Service or the auditing departments of various states may disallow some of the deductions on the grounds that they should have been charged to the for-

eign subsidiaries. However, the odds against that occurring are very good. The returns do not get audited every year. Furthermore, in view of X corporation's total domestic income, the expenses, including those attributed to the foreign subsidiaries, appear to be reasonable in amount, and, accordingly, are not apt to be questioned.

Appellant undercharged its subsidiaries and obtained tax benefits similar to those obtained by corporation X. If Appellant had dealt with its subsidiaries on a genuine arm's length basis and had charged the subsidiaries either an amount which it would have charged truly independent corporations, or had charged the subsidiaries an amount which a truly independent corporation would have charged its subsidiaries, the charges would have been much greater than the amounts actually charged. If such arm's length charges had been made, its taxable income for federal and state tax purposes would have been substantially increased, and the taxable income of the foreign subsidiaries would have been substantially decreased.

By undercharging the foreign subsidiaries, their taxable income and their foreign taxes were increased but at the same time the Appellant's domestic income and domestic taxes, both federal and state, were reduced by substantially larger amounts. Furthermore, as an added bonus, when the foreign subsidiaries declared dividends to the Appellant, the Appellant was able to claim credit not only for the correct amount of foreign taxes, but for the excess taxes as well.

In view of the foregoing, Appellant clearly has no grounds for complaining of double taxation.

B. The Use of Different Methods of Apportioning Income Does Not Necessarily Result in Double Taxation.

Appellant contends that the use by the states of the formula method to apportion worldwide income, whereas foreign countries use the separate accounting method, neces-

sarily results in double taxation of the same income. It is possible that a case resulting in double taxation will arise, but judged by experience of the past, such instances are apt to be quite rare.

The various states of the United States have imposed taxes on or measured by corporate income for over 60 years. There has never been a time when all of the states employed the same apportionment methods. In the earlier days some of the states employed one or the other of various formulae, but until comparatively recently, many of the states permitted or even required the use of separate accounting.

Now all of the states employ some type of formula for apportioning the income of a single corporate unitary business. The formulae used differ substantially. Most of the states use the three factors of property, payroll and sales as does California. Some, however, use a formula consisting of property, manufacturing costs and sales. This results in favoring states where manufacturing operations are carried on. One state, Iowa, uses a formula consisting of the single factor of sales. Colorado grants taxpayers an option. They may either employ a two factor formula of property and sales or the three factor formula of property, payroll and sales. Several states have recently given extra weight to the property factor, which, again, usually favors the state where manufacturing operations are carried on in which there is apt to be a large amount of property.

In 1936 California instituted the combined report. Shortly thereafter it was adopted by Oregon and Alaska and by a number of other states in subsequent years. It is now employed by approximately one-third of the 45 states which tax corporations on or measured by income. The other two-thirds of the states still permit or require the use of separate accounting to apportion income from transactions between affiliated corporations.

If, as Appellant claims, the use of different methods of apportioning income by different taxing jurisdictions nec-

essarily results in double taxation, one might expect there would be a number of cases so holding. However, so far as is known, there are no such cases. One might reasonably infer therefore that double taxation resulting from the use of different apportionment methods is not a serious problem. It is difficult to see why it would be any more serious in cases where the income of foreign corporations is included in a combined report. For further discussion of this subject, *see* Keesling, *The Combined Report and Worldwide Businesses*, TAXES—The Tax Magazine, April, 1982, 304, 307.

C. The Rationale of *Japan Line* Is Not Applicable Here.

Throughout its brief, Appellant assumes that the principle of *Japan Line, Ltd. v. County of Los Angeles*, 441 U.S. 434 (1979), a property tax case, should be extended to the corporate income tax field. A similar assumption was made in *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 448 (1981). This Court repudiated this assumption as follows:

> "Appellant's attempted analogy between this case and Japan Line strikes us as forced. That case involved ad valorem property taxes assessed directly upon instrumentalities of foreign commerce. As has been noted, the factors favoring use of the allocation method in property taxation have no immediate applicability to an income tax."

In *Peck & Co. v. Lowe*, 247 U.S. 165 (1917) this Court held that a tax on income from exports was not a tax on exports in violation of Art. I, Sec. 9, Cl. 5 of the United States Constitution which prohibits Congress from levying a tax on exports. One of the reasons for this holding was that the tax arises after the exportation is completed.

Similarly, it may well be urged that a tax on income from commerce is not a tax on commerce. *See*, Keesling, *The*

Impact of the Mobil Case on the Apportionment of Income, Brigham Young University L.R., 96 (1981) wherein it is urged that *Japan Line* should not be applied to the income tax field for reasons similar to those advanced by this Court in *Mobil*. It was further stated that if *Japan Line* is extended to the income tax field, it should be limited to instances where a foreign corporation is taxed by a foreign country on its entire worldwide income and is also taxed on a portion of the income by one of the states. It should have no application in cases such as the instant one where the parent corporation is a domestic company.

One of the reasons for this Court striking down the tax imposed by the County of Los Angeles upon a portion of the movable property owned by *Japan Line* which had been taxed by Japan upon its entire worldwide movable property was to prevent the possibility of recrimination. In instances, such as the present one, where the parent corporation is a domestic company, there is no substantial likelihood of recrimination. Foreign countries could care less how the states of the United States tax domestic companies.

D. The Fact That Labor and Property Costs in Foreign Countries Are Lower Than in the United States Does Not Render the Combined Report Invalid.

Appellant cites statistics indicating that labor and property costs in foreign countries are substantially lower than in the United States. It then argues that the use of the formula method which the combined report makes applicable to apportioning the income of two or more affiliated corporations engaged in the conduct of a unitary business, results in the taxation of income earned in foreign countries. (App's. Br. 12.)

The Court's attention is called to the case of *John Deere Plow Co. v. Franchise Tax Board*, 38 Cal.2d 214 (1951) where a similar argument was made. The taxpayer intro-

duced evidence to the effect that wage rates in California were 50% higher than the national average, and that property values in California were very substantially nigher than in the national average. It argued that the use of a formula which includes the factors of property and payroll necessarily results in the taxation of income earned in other states. The California Supreme Court rejected the argument and upheld the use of the formula method on the ground that it is a reasonable method for the apportionment of income, and is not arbitrary or capricious simply because it includes factors which may deviate somewhat from the average.

It is recognized that the formula method does not result in a precise answer but only an approximation of the amount of income earned in any one jurisdiction. Accordingly, it should be used only in cases, such as the instant case, where a precise answer cannot be obtained. Keesling, *The Combined Report and Worldwide Businesses*, TAXES—The Tax Magazine, April, 1982, 306.

Furthermore, in the apportionment of the income of a unitary business, the use of the formula method is far preferable to the use of separate accounting, the use of which would constitute an attempt to separate the inseparable.

E. Restricting the Use of the Combined Report to Domestic Corporations Will Result in Widespread Tax Avoidance in Some Instances and in Excessive Taxation in Others.

1. Tax Avoidance.

Appellant acknowledges that its domestic business is unitary, and, further, that it is permissible for the states to use the combined report in apportioning the income of domestic corporations engaged in the conduct of a unitary business. It insists, however, that the income of an affiliated foreign corporation should not be included even though its income is derived from a unitary business conducted in part in the United States. If such a rule were adopted, corpo-

rations doing business in the United States could avoid state income taxes with impunity by selling their goods to foreign subsidiaries at cost or a very low markup. The factual situation which gave rise to the combined report is illustrative. A number of California corporations which were engaged in very profitable businesses sold their product at cost to wholly owned subsidiary corporations in other states and foreign countries. As a result, they reported no income subject to the California franchise tax.

This strategy worked for the income years 1928, the first year subject to the California franchise tax, through the income year 1934. However, in the spring of 1936 California adopted the combined report which required every corporation engaged in the conduct of a portion of a unitary business in the state to file a report including the income, not only of domestic subsidiaries, but also the income of foreign subsidiaries as well. As a result, the California corporations involved were no longer able to avoid the California franchise tax, and, instead, were required to pay several hundred thousand dollars per year in taxes which, except for the combined report, would not have been collected.

If Appellant's suggestion had been followed, the state could have applied the combined report in the case of the domestic subsidiaries but could not have applied it in the case of the foreign subsidiaries. Thus, no income would have been attributable to California resulting from the sale to foreign subsidiaries of products manufactured in the state.

Sales by domestic corporations to foreign subsidiaries are common, not only in California, but also in the other states which have adopted the combined report. Hence, if the income of foreign subsidiaries is to be exempt from the combined report requirement, the loss of much needed revenue will be substantial. Furthermore, corporations which make sales to domestic subsidiaries but do not engage in similar foreign transactions will complain bitterly of the

discrimination against them, with the result that the combined report which has proven salutary in the prevention of tax avoidance and promoting equality of treatment between single businesses and multi-corporate businesses may be jeopardized in its entirety.

2. Excessive Taxation.

If the combined report is restricted to domestic corporations, there may well be excessive taxation in many instances. This point may be illustrated by reference to *Superior Oil Company v. Franchise Tax Board*, 60 Cal.2d 406, 34 Cal.Rptr. 545 (1963). Superior was a non-integrated company engaged in the exploration and drilling for oil and extraction of oil which was sold at the wellhead. According to separate accounting computations, it realized a net income in California of some $10,000,000 and a net income in Oklahoma of some $2,000,000. but lost some $9,000,000 in other states. Thus, it realized an overall net income of $3,000,000. The California Supreme Court held that the entire business was unitary, and, accordingly the California income should be computed by apportioning the total net income of $3,000,000 by California's apportionment formula.

Now suppose that Superior had abandoned its operations in all states other than California and Oklahoma, and instead had organized a subsidiary corporation to explore and drill for oil in various Canadian provinces. The Canadian corporation's expenditures exceeded its receipts by $9,000,000. Thus, Superior's total income in the hypothetical case is $3,000,000, the same as in the actual case. Inasmuch as the operations in Canada are an integral part of Superior's business, its income from California sources would be computed by the apportionment formula, with the result that there would be attributed to California only a portion of the overall $3,000,000 net income. If, however, the income of a foreign corporation cannot be included in a combined report, as Appellant suggests, then Superior would be

taxable on an income of $10,000,000 in California and 2,000,000 in Oklahoma or an amount of income $9,000,000 in excess of the actual amount of income.

Reference should also be made to *Exxon Corp. v. Wisconsin Dept. of Revenue*, 447 U.S. 207 (1980). Exxon contended that although it made substantial profits overall, it lost money in the marketing states, including Wisconsin. Suppose that instead of endeavoring to find markets for its product in various states in the United States, it had organized a marketing subsidiary which operated in one or more foreign countries. Suppose further that Exxon's income from the production of oil in the United States computed according to separate accounting methods amounted to $200,000,000, and that its foreign marketing subsidiary lost $100,000,000. As a result, Exxon's overall income is $100,000,000. If the combined report is used, only a portion of Exxon's total income would be attributable and taxed by one or more of the producing states. If, however, the combined report cannot be employed, then *Exxon* would be subject to tax by the producing states on an income of $200,000,000.

Again, suppose three affiliated corporations are engaged in the conduct of a unitary business partly in the United States and partly in a foreign country. One of the corporations is a domestic company and the other two are foreign. According to separate accounting computations, the corporation doing business in the United States realizes a profit of $1,000,000. One of the foreign corporations likewise realizes a profit of $1,000,000 and the other foreign corporation loses $1,000,000. Thus, the overall net income of the three companies is $1,000,000. Some portion of this amount would be attributed to the United States if the combined report method were used. If, however, the income of the foreign corporations cannot be included in a combined report, then the corporation doing business in the United States will be subject to tax on $1,000,000 and one of the

foreign corporations will likewise be subject to tax on a similar amount.

The possibilities of excessive taxation resulting from restricting the use of the combined report are at least as probable as the possibilities of double taxation from its continued use.

F. The Use of Separate Accounting Will Not Result in the Nation Speaking with One Voice.

Appellant asserts that the use of the combined report prevents the nation from speaking with one voice. (App's. Br. 27.)

The use of separate accounting, as Appellant suggests, will not remedy this matter, but, instead, will aggravate it and, in addition, will result in tax avoidance on a wholesale scale in many cases and in excessive taxation in others.

The arm's-length standard, which supposedly is an essential element of the separate accounting procedure, is usually artificial or contrived. The reason for this is that most corporations do not have a sufficient volume of genuine arm's-length transactions with truly independent entities to form a basis for a genuine arm's-length standard for dealing with subsidiaries. For much the same reason, the experience of other companies in the same line of business may not be helpful.

Lacking a genuine arm's-length standard, corporations selling goods or services to subsidiaries must develop their own conceptions as to the proper terms of such transactions. Such terms necessarily represent little more than a guess or conjecture on the part of the corporation, and may be biased in order to reduce the burden of taxation. Furthermore, representatives of the Internal Revenue Service or of state or foreign taxing agencies, upon the audit of returns, may well, and often do, reach different conclusions. Thus, instead of enabling the nation to speak with one voice, the use of the separate accounting procedure results in the nation

speaking with a babble of voices—as many as there are taxpayers and taxing agencies concerned.

For an emphatic and detailed criticism of the arm's-length standard, *see Controller General's Report to the House Committee on Ways and Means*, September 30, 1981. For an earlier severe criticism of the arm's-length standard, *see* Altman and Keesling, *Allocation of Income in State Taxation*, Ch. V, "Principles of Allocation of Business Income" and Ch. VIII, "Apportionment of Income of Affiliated, Related, or Controlled Taxpayers" (Commerce Clearing House, Inc., 1946) (2d Ed. 1950).

Conclusion.

Appellant insists that its foreign subsidiaries function as separate, independent businesses. However, Appellant had a hand, and, in some respects, a heavy hand in virtually all phases of the subsidiaries' operations. Furthermore, its charges for services rendered its subsidiaries were not charged on the basis that a corporation organized for profit would charge a truly independent entity. Instead, many of the services were charged on the basis of cost, and others not charged at all.

Under these circumstances, it is respectfully submitted that the lower court's decision upholding the use of the combined report should be upheld.

Respectfully submitted,

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